October 17, 2007

Mr. David Ikari, Chief
Dairy Marketing Branch
California Department of Food and Agriculture
560 J Street, Suite 150
Sacramento, CA 95814

RE: October 10-11, 2007 Class 4a and 4b Hearing -- Post Hearing Brief

Ms. Hearing Officer and Members of the Panel:

Hilmar Cheese Company, Inc. appreciates the opportunity to submit the following post-hearing brief to amplify portions of our testimony presented in Sacramento on October 10th and 11th, 2007. The paragraphs that follow build on the propositions that we put forth in our testimony.

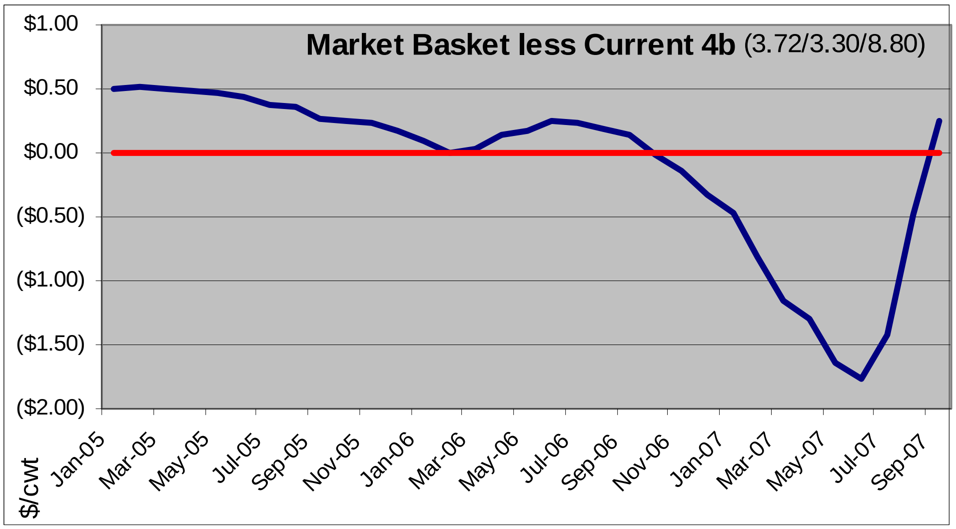
The current high regulated 4b price has created a very disorderly marketing situation. The combination of too high regulated price and classified prices (different prices for different uses of the same product) would devastate and ultimately cripple any agricultural industry - beef, strawberries, grapes, almonds or milk. This combination (which now exists) has created very disorderly marketing of raw milk in the State of California.

The Compromise

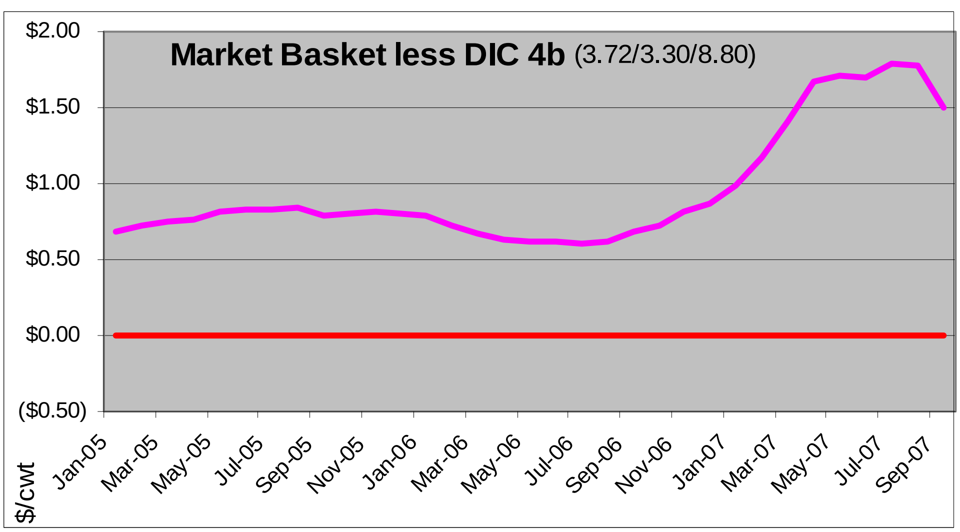
The "compromise" that the panel continually asked about during the hearing happens all the time as cheese plants pay premiums based on milk protein levels and the various end products that the cheese plants produce. The dairymen trade associations and the cooperatives that have no cheese processing simply want to regulate and force higher payments into the pool so that some of the whey values get redistributed to them.

The compromise is to eliminate the whey factor so that cheese plants and their suppliers can negotiate market-based premiums that go directly to those supplying the cheese plants - be they individual producers or coops. As you know, our internal pay system, known as Market Basket is based on individual dairies' milk components and product pricing derived from those markets we participate in. Our Market Basket milk pay price already effectively reaches this compromise, if the regulated price is low enough. By maintaining the whey factor in the regulated price, CDFA has regulated and pooled key economic signals to the extent that milk is not clearing the market (too much milk and not enough plant capacity). The only way this can be rectified is to let the market establish market clearing prices for milk. To do this the DIC proposal must be enacted. HCC has always led the way in market based milk payments, but we have stopped paying premiums to a large extent as the regulated price has been far in excess of our market-based milk pay price.

Below we provide two graphs. The first depicts the amounts that our Market Basket payment has been either over or under the regulated 4b price for the last 33 months. On this graph, if our market basket payment was under the regulated price, we had to pay the regulated price, which was above our price – and we paid no premiums. The amount we had to pay in excess of our Market Basket price during this 33 months totaled approximately $49,000,000 or an average of $1,500,000/month.



The next graph shows what our Market Basket payment would have looked like had the DIC proposal been in effect. This graph shows a pay price above the regulated price and effectively means that we would have paid premiums above the regulated price throughout this period.



The dairy trade associations and coops without cheese processing want to regulate premiums into the pool so they can control the payments. Once they control the payments the market will not work. CDFA must lower the regulated price:

1. To let the market work with appropriate economic signals between a buyer and a seller so that the market is cleared in a more orderly fashion through over-minimum payments that reflect market conditions and connects the milk suppliers of cheese plants to cheese plants, as key suppliers should be, rather than having market signals go into the pool and disappear to those who are not investing.

2. To send the signal that CDFA is not the end all in establishing milk prices. If CDFA made this clear by lowering the regulated price, there would be "compromise" immediately as coops and milk suppliers would come to agreements with their customers. As long as coops, trade associations and dairymen think CDFA establishes final prices, they will keep coming to CDFA to solve their problems.

The compromise is for CDFA to role back the regulated price and encourage coops to actually market milk, rather than ask CDFA to do it for them. Minimize the regulated price and push us to be marketers. It may be "tough love," but it is what we need.

Milk Over-supply Additional Information

The attached file offers excerpts from internal documents showing comments on oversupply of spot milk in California this year.

4b CDFA Hearing
Brief Log 07.doc

Cheese Market News Article

The attached file includes a copy of an article we wrote for Cheese Market News dated 10/12/07.

CMN Guest Columnist
article 10-2007.pdf

Documentation of 2007 processing capacity issues

2/2/07 The floodgates opened up this week from spot suppliers. I turned down milk from -----, ----- (first call all year from them), -----, and ----- for UF. This change sounds more and more like last year's early flush.

2/16/07 Spot milk availability continues to grow. I received calls from just about everybody this week. Fortunately, with components falling we had an appetite for more. Will purchase 70 spot loads this week (-----, -----, -----, -----) and 46 loads next week (-----, -----, -----).

3/30/07 Spot availability is widespread between the flush season and holiday plant schedules.

4/3/07 Getting calls from ----- shippers who aren't getting their milk picked up.

4/18/07 Spot milk continues available with calls this week from -----, -----, and -----.

4/20/07 Spot milk is very available.

4/24/07 Spot milk is still available.

4/27/07 Spot availability seems as strong as ever. ----- has contacted me 2 weeks running looking to place UF.

5/18/07 Spot milk availability is good ---------.

5/22/07 Spot availability is strong going into Memorial Day weekend. We'll be giving help to -----, -----, -----, ----- and ----- over the weekend.

5/25/07 Spot availability is predictably strong from holiday weekend although -----, heavy class 1 supplier, canceled their need for help. We'll be taking loads from -----, -----, -----, and ----- during the week.

6/1/07 Spot milk is still very available. Some bottlers didn't need help but some did which I had to turn away. We'll not be purchasing any spot milk next week.

6/5/07 Spot availability still appears strong.

6/6/07 Spot availability unchanged with calls nearly daily looking for homes.

6/7/07 Spot availability seems to be picking up. ----- is having ----- plant problems.

6/8/07 Spot availability still strong. Will be purchasing no spot loads ---------- next week.

6/11/07 Spot load offers have come from -----, -----, and ----- since the weekend all with plant issues.

6/12/07 Spot availability MUST be strong since no one could take any from us last couple days.

6/14/07 Spot milk still available.

6/15/07 Spot availability continues strong. Receiving calls almost daily - mostly from fluid handlers.

6/22/07 Spot availability is picking up. Had multiple calls last couple days. ----- dispatcher said they "still have plenty of milk" despite the heat.

6/29/07 Spot milk seems about the same. Plenty of holiday availability plus ----- mentioned they are seeing a "mini-flush."

7/9/07 Spot availability continues strong with calls from ----- and -----.

7/10/07 Spot availability is still strong seemingly as no one has been hit by the heat.

7/11/07 Spot availability appears to be staying strong. Still getting at least 1 call per day.

7/12/07 Spot load availability came on strong today getting calls or emails from everybody. Seems heat wasn't so bad and/or demand not so good.

7/13/07 Spot availability is unchanged - got more calls today.

7/16/07 Spot availability is still strong. On top of getting calls from everyone last Thur & Fri, today ----- called asking for help after their evaporator was down most of the weekend.

7/17/07 Spot availability continues strong amplified this week by -----'s continuing plant problems.

7/18/07 Spot availability still good.

7/19/07 Spot availability still strong with renewed phone calls today.

7/20/07 Spot availability still strong.

7/24/07 Spot availability is very strong. Getting calls nearly everyday. Mel reported backups at many ------supplied facilities and ----- reported today they are dumping milk.

8/9/07 Spot availability continues strong but less frantic. Not hearing of milk on the ground since last week's heat.

8/10/07 Spot availability - still lots.

8/14/07 Spot availability still strong. Everybody's got extra.

8/17/07 Spot availability still very high.

8/21/07 Spot availability has lessened but still strong.

8/27/07 Spot availability still strong. Despite the heat, ----- and ----- are still full.

9/5/07 Spot availability while removed this week due to the heat is picking up for next week. Received a couple calls already for next week.

9/11/07 Spot availability is back to being very high. ----- continues to be backed up from last weekend plant issues and now ----- has USDA on-site at -----. In addition, ----- phoned about this coming weekend already.

9/14/07 Spot availability is still strong. There were calls turned away even after buying 24 spot loads for next week.

9/18/07 Spot availability continues strong. I've already gotten a call from ----- regarding next week

9/27/07 Spot availability is still strong. Getting calls from the usual folks.

10/12/07 Spot availability jumped this week with plant outages at -----, -----, and ----- cheese. Turned down ----- and -----.

GUEST COLUMNIST

CMN Exclusive!

Perspective: Dairy Policy

John Jeter is president and CEO of Hilmar Cheese Co. He contributes this column exclusively for *Cheese Market News®*.

Opportunities? Maybe...

We are all aware of the very different and dynamic world dairy situation that has driven dairy prices to record levels. As we try to adjust our businesses to these new dynamics, almost all agree that the United States is in a great position to play a much bigger role in world dairy trade in the future, rather than sitting on the sidelines as we've done in the past. The United States has one of the largest incremental areas of arable land with potential to produce much of the world's new dairy product needs in the years to come — at least the demand that will be met through global dairy trade. Additionally, we have some large, established milk production regions that may have growth potential as well. Conversely, the European Union (EU) is much more limited in their growth opportunity, and Oceania as a region has not met the production predictions of five to eight years ago. Many, including this author, believe that the United States has the potential to be the supplier of choice for incremental dairy products to the world — not to mention the amazing opportunity we have by being in the middle of one of the largest, most sophisticated and safe food systems in the world — the United States.

With this potential opportunity ahead of us, a critical question is "what is going to stop us from moving forward to take advantage of this?" An important corollary to this is "what has kept us on the global dairy sidelines in the past and do these same barriers still exist?" There may be a connection.

First, a quick look back ...

When most U.S. dairy policy — and all agriculture policy for that matter — was designed in the 1930s, it was really in response to the Dust Bowl, the Great Depression and the fact that the majority of the U.S. population was involved in some way in production agriculture. Giving agriculture and dairy a stimulus and supports accomplished part of what the New Deal was all about. The problem is that U.S. agriculture policy, in particular dairy policy, has essentially remained the same with only minor changes since the 1930s. And, as we are all aware, the world and U.S. food markets have changed immeasurably.

U.S. dairy policy was designed to mitigate risk and protect farmers because no real valid cooperative movement existed during that time. However, once valid cooperatives were formed, policy did not change. In fact, these same risk-mitigating policies became even more deeply imbedded. The result was an industry that was risk adverse and not well suited for new opportunities or threats — be they in the United States from soy, bottled water or bellywashes for share of stomach; or overseas from less regulated, low cost producers; or the EU where dairy policy had a much less regulated price surface and had a component that recognized the importance of international markets. The cornerstones of U.S. dairy policy — regulated, classified, pooled prices and the support program — created an industry and leadership culture that largely focused on managing pool proceeds and margins while minimizing risk through use of government supports. Simply put, a significant amount of human and capital resources were spent on the wrong things over many years. The result, as one eminent dairy philosopher put it, "if you were good, you could win the 100 in 14 flat." And that is not a compliment ...

The system worked for a while when we in the United States just competed with each other. The problem is that we are now in a world where we have to compete with a whole new class of competitors. One set of competitors includes the non-dairy beverages and ingredients

Turn to JETER, page 6 ⇨

NEWS/BUSINESS

JETER

Continued from page 4

that have invested in new products and directions over a long period of time. The other set of competitors includes large, global dairy companies found in Oceania and the EU where they have a far different approach to dairy policy — an approach that required a devotion to the development of resources and competencies associated with global dairy trade. The results were competitors who have a deep understanding of where their products could and did fit into the sophisticated food systems throughout the world, and the resources and capabilities to get them to market. One might say that their long-term success depended on it. Success in our system in the United States depended on how to get the regulators to adjust make allowances and pooling requirements with a focus on products that were treated most beneficially relative to the classified price and supports.

The unintended outcome of this was that many dairymen and dairymen trade associations did not understand the long-term importance of investment in products, markets and customers and began to focus on the regulated price to enhance revenue at all costs.

The current whey factor built into the regulated price for milk going into cheese is a perfect example. All incremental revenue from a cheesemaker's whey operation, after paying the manufacturer to make it, goes to the dairymen via the regulated price. But, actually, there is one more step — the revenue is pooled before it is paid out, which further blunts any economic signals. Using the regulated price to capture whey revenues via the classified price and then redistributing them in pools has gutted the cheese industry over the past two years. It was the ultimate in government intervention and has sped up consolidation of the industry to the detriment of many.

As is typical in today's thought, the regulated price was viewed as a way of increasing revenue, which it is not. The regulated, classified price only divides revenue and re-allocates economic resources. It does not in any way create value; it just distributes it differently. And for that reason alone, it must be de-emphasized and diminished if we are to survive and thrive in this dynamic global dairy economy ahead.

If we continue to have a regulated price, it must be low and not intrusive. We need manufacturing milk prices created from surveyed, transparent, market transactions that incorporate the unique risk and market elements of those involved. Economic resources will then be allocated very efficiently as a result. The market will work and we, the U.S. dairy industry, will work in the global market and capture a very fair (earned) share of the opportunities ahead.

Critical to this issue is the current milk hearing in California. The original request for the hearing came from a group of cheesemakers asking the California Department of Food and Agriculture to eliminate the whey factor and step away from the regulation that has devastated the cheese industry and created chaos. Then the alternate proposals came from those focused on the classified price and pooling system as the answer/end all. In almost every case, the proposals are actually more regulation via new credits or price classes. These would add complexity and ultimately say that regulators can allocate resources better than the market. More price classes and credits in the pooling system are not the answer. We clearly need to reduce and simplify.

The U.S. dairy industry is at a critical juncture. Will we continue down the path we have been on or will we take some big steps toward charting a new course? Will we move closer to the marketplace allocating resources, or will we continue to think that regulators can do it better?

Opportunities? Maybe... CMN

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